

# INSIDE ARBITRATION: THE RISE OF GIGA PROJECTS IN LATIN AMERICA

07 February 2019 | Global

Legal Briefings - By **James Doe**, **Christian Leathley** and **Noe Minamikata**

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Over the last few decades countries such as Brazil, Mexico, Chile, and Panama have embarked on ambitious multi-billion dollar "giga projects", which have frequently been in the global spotlight, but not always for the right reasons.

In this article, James Doe, Christian Leathley and Noe Minamikata consider the issues that have arisen on some of these Latin American giga projects and explore what likely lies at the heart of these high-profile and often controversial disputes.

On any large-scale construction and engineering project, contentious issues – both foreseeable and unforeseeable – are bound to arise regardless of the country or region in which it is based.

These issues can range from adverse ground conditions, supply shortages and labour disputes, to changes in law and prevailing economic and political conditions, as well as more generic commercial issues such as under bidding the contract price. The risk of problems increases where the project involves complex engineering, multiple contracting parties and a wide range of investors as well as other stakeholders, which cause further political, social and economic complexities.

Where these issues are not anticipated at the outset of the project and therefore inadequately provided for in the relevant project agreements (including in the contract price) or where they are not effectively dealt with as they arise, all this can lead to significant delays and cost overruns which, in turn, can develop into costly and protracted arbitration cases.

Projects in Latin America are no exception to this phenomenon. Whilst significant differences exist across the region, Latin America has one of the poorest track records for project delays and cost overruns on large-scale projects, as compared to some other regions of the world.

## **GIGA PROJECTS CAN GIVE RISE TO GIGA CLAIMS AND DISPUTES**

### **THE PANAMA CANAL EXPANSION PROJECT**

The Panama Canal Expansion Project is reported to have incurred a number of serious problems before its opening in 2016. These included the suspension of works over disputed payments and disruption claims related to adverse ground conditions, amongst others. The project, in turn, has suffered huge cost overruns of over US\$2.5 billion and almost a two year delay to commencement of operations, which has resulted in millions of dollars in lost revenues for the operator.

These problems have reportedly led to several dispute adjudication board decisions and seven high-value ICC arbitrations, the first of which was commenced in December 2013 and only concluded in July 2017. The legal costs of the employer, the Panama Canal Authority ("**ACP**"), have been reported to be in excess of US\$22 million for the first arbitration alone.

Two years on from the opening of the project, the majority of ICC arbitrations have yet to be concluded or settled. Further, in August 2018, the contractor consortium group, Grupo Unidos por el Canal, S.A. ("**GUPC**"), filed a separate investment treaty claim against Panama pursuant to the Spain-Panama bilateral investment treaty. As a result, the fallout from this particular giga project could continue for many years to come.

### **THE PANAMA CANAL EXPANSION PROJECT**

The Panama Canal Expansion Project (also known as the Third Set of Locks Project) involved the creation of a third set of locks for the Panama Canal. The expansion doubled the Canal's capacity and has allowed larger ships to use the Canal. The project commenced in 2009 and was due to be completed in 2014, but numerous delays on the project delayed its opening to June 2016. The original cost of the project was US\$3.1 billion, but increased to approximately US\$5.3 billion (as at 2017).

### **THE NEW INTERNATIONAL MEXICO CITY AIRPORT PROJECT**

Another multi-billion dollar project that has been overshadowed by controversy since its inception is the New International Mexico Airport ("**NAICM**") Project, which is currently thought to be at least US\$4 billion over budget despite being only 30% complete.

In addition to the major cost overruns, numerous other issues have arisen on the project, including allegations of corruption and tender irregularities. Several lawsuits have reportedly been filed against the airport group, including an ICC arbitration case commenced by Parsons, the project manager. A wave of investment treaty claims are also expected if Mexico's president, Andrés Manuel López Obrador (commonly known as "AMLO"), adheres to his promise to cancel the project in response to a public consultation in which nearly 70% of those polled voted for the project to be cancelled.

### **THE NEW INTERNATIONAL MEXICO CITY AIRPORT PROJECT**

The New International Mexico City Airport Project is located on part of the dry lake bed of Lake Texcoco, roughly 25km northeast of Mexico City, Mexico. The project is technically complex and involves the construction of a main terminal of 743,000 square meters, three runways and a capacity of 66 million passengers annually. By the final stage of construction in 2065, the airport is expected to have a capacity of 125 million passengers annually. The original project cost was approximately US\$9 billion, which has increased to US\$13-14 billion.<sup>1</sup> The initial stage of construction of the project began in 2016 and was scheduled for completion in 2020.

The Panama Canal Expansion Project and NAICM Project are perhaps extreme examples of the types of problems that giga projects can suffer in Latin America. Nevertheless, they stand as useful case studies of the types of problems major projects can suffer in the region. It is also possible to identify from these two projects some common factors, which not only contribute to the destabilisation of large-scale projects, but also trigger major arbitrations.

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## **COMMON ISSUES ON HIGH VALUE AND COMPLEX CONSTRUCTION AND ENGINEERING PROJECTS IN LATIN AMERICA**

There are certain factors that contribute to claims and disputes on high value and complex construction and engineering projects, regardless of jurisdiction. These can range from inadequate planning and early design work to poor project management and mismanagement of change during construction. The following appear to be factors that are more common to projects in Latin America.

### **UNDER-PRICING**

Under-pricing of bids is a widespread issue that affects the construction industry in many jurisdictions, although perhaps even more so in Latin America due to the scarcity of big-ticket infrastructure projects, leading to a greater competition between regional contractors to win the work. On the Panama Canal Expansion Project, for example, GUPC's initial bid of US\$3.1 billion (which was eventually accepted as the contract price) is reported to have been approximately US\$1 billion lower than its nearest competitor.

Under-pricing also tends to arise where the bid process is governed by strict public procurement rules (as most large-scale infrastructure projects in Latin America are), which require criteria such as transparency and budget constraints to take precedence over quality or a more innovative technical offering.

Of course, the cheapest bid does not always represent the best value in the long run. As the works progress, it often becomes increasingly apparent that the original bid price is insufficient to cover the risks assumed by the contractor. Partly as a consequence of that, claims begin to increase in quantity and value as the contractor attempts to recover the shortfall. Due to the size of sums in issue and the commercial and political pressures facing both parties, such claims often lead to arbitrations as both parties adopt entrenched positions. These arbitrations further hinder the progress of the project by diverting crucial management resources away from the works.

Given the scale of the sums involved and the duration of the construction phase, it is often impossible for the contractor to wait until the works are completed to recover the additional sums claimed because of much needed cash flow.

Project related claims also arise due to the paralysis caused by such cost overruns. Given that giga projects often involve public funding, the scrutiny and intervention of local "fiscal" authorities (often called Contraloria) can be brought to bear on projects. Public officials requested to make cost increases are fearful of the civil and criminal sanctions that can flow from a proven mismanagement of public funds. Accordingly officials often do not sign off on necessary cost increases, instead preferring to allow disputes to accrue and leave the resolution to arbitral tribunals. This paralysis is all too common and can lead to major delays.

## **LABOUR SHORTAGES**

Several years of recession and the fall in commodity prices have impacted the region's labour market. According to the World Economic Forum, Latin America has the largest skills gap in the world, and regional construction firms often struggle to find workers with the right skills.<sup>2</sup>

A shortage of adequately trained and experienced workers in the country, as well as project management resources, can materially affect the productivity and timely completion of construction projects. This may be exacerbated further if local laws require a minimum level of local labour to be employed during construction. These local content requirements are a common feature of Latin American projects.

## **STRIKES AND DISTURBANCES**

Although not universal across the region, strong labour unions are known to have had a significant impact on construction projects in Latin America. In jurisdictions such as Brazil and Mexico, where labour unions play a prominent role, construction projects can be at greater risk of strikes, labour disturbances and even riots instigated by the unions seeking to improve their negotiating position in relation to collective bargaining agreements.

Failure to manage the relationship with labour unions can lead to periods of low productivity. These, in turn, can lead to project delays and cost overruns, which increase the probability of arbitration. If, as is often the case, the mismanagement of labour relations is attributable to both the contractor and the employer, the allocation of risk of any resulting delay is not always clear-cut. More generally, the allocation of responsibility for delay, whether caused by labour relations or other issues, can be one of the most challenging aspects of giga project arbitrations.

Disturbances can also manifest themselves through local indigenous communities (comunidades) interrupting projects. The environmental, property and health related claims that might impact such communities are being supported or promoted by NGO's who are working with the communities. The organisation of such communities is becoming extremely common, resulting in local court actions that can suspend major projects from progressing.

## **POLITICAL UNCERTAINTY**

The success of major infrastructure projects in Latin America can often depend on the prevailing political climate at the time. A prime example of this is the NAICM Project discussed above.

Jurisdictions such as Mexico permit public contracts to be terminated on grounds of general interest, and if continuing with the work is determined as not being beneficial to the state.<sup>3</sup> Whilst contractors of cancelled projects would typically be entitled to compensation where a project is cancelled, disagreements inevitably arise as to the level of compensation to be paid, which can frequently lead to high-value disputes. The authors' experience suggests that construction contract terminations are on the rise across the international construction market, leading to an increase in construction arbitrations around the globe, including those in Latin America.

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## Corruption scandals

Brazil's "Car Wash" investigation in 2017 exposed widespread corruption not only within Brazil but across Latin America, including the revelation that Odebrecht, the biggest contractor in the region, had paid millions of dollars in bribes to government officials in order to secure public contracts.

Under the laws of many Latin American jurisdictions, contracts obtained illegally, such as through corruption, are rendered null and void. The scandal has led to numerous Odebrecht contracts – such as the US\$1 billion contract for Ruta del Sol 2 in Colombia and the Gasoducto Sur Peruano pipeline in Peru – to be cancelled. These have, in turn, triggered investment treaty arbitration claims against Colombia and Peru by other contractors.

Since the investigation, governments in Latin America have become more cognisant of the need to tackle corruption in the construction industry. Corruption, however, continues to pose a real risk for contractors and suppliers operating in the region. As the Car Wash scandal has demonstrated, even where corrupt practices are committed by others within a consortium or even within different parts of the supply chain, the fallout can jeopardise the entire project and bring a slew of associated disputes and arbitrations.

The consequence is greater vigilance, but also the obsessive drive for transparency. In this latter regard, we have already begun to see how giga projects with state owned entities are now becoming seriously hamstrung because of the constant need for transparency in every aspect of procurement and contract management, in order to avoid any criticism of corruption. Thus the pendulum swings from one side to the other – often resulting in complications for such projects.

## **CONCLUSION**

Large-scale complex construction and engineering projects are inherently risky. However, those in Latin America can be particularly challenging given the significant potential for issues to arise, which are outside the direct control of the parties. The ongoing infrastructure investment gap in the region also means that projects are often subject to strict financial and also political constraints, with limited scope for cost overruns to be financed by the owner.

Given the significance of giga projects to the economy of the host country, determining responsibility for cost overruns can create severe political as well as commercial problems for the parties involved. It is therefore crucial that, when participating in large-scale projects in the region, parties to construction contracts insist on, and actually operate, robust project and claims management procedures, which enable issues to be addressed promptly as they arise.

If disputes become unavoidable, it is important that project participants understand their legal position under the local law and the contract, and prepare their legal, factual and technical case properly. Disputes of this nature tend to be lengthy and complex and require significant amounts of evidence in order to achieve success, so having the right information management systems in place is essential.

Footnotes:

1 According to the study "¡Ojos a la Obra!" conducted by the public policy think tank, México Evalúa, the cost of the project is expected to be in the region of US\$14 billion. According to other estimates, the figure is around US\$13 billion.

2 <https://www.weforum.org/agenda/2018/03/latin-america-has-the-biggest-skills-gap-in-the-world-here-s-how-to-bridge-it/>

3 Article 60 of the Law of Public Works and Related Services.

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## KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



**JAMES DOE**  
PARTNER AND JOINT  
GLOBAL HEAD OF  
CONSTRUCTION  
DISPUTES, LONDON  
+44 20 7466 2583  
James.Doe@hsf.com



**CHRISTIAN  
LEATHLEY**  
PARTNER, NEW YORK  
  
+1 917 542 7812  
Christian.Leathley@hsf.com



**NOE MINAMIKATA**  
PROFESSIONAL  
SUPPORT LAWYER,  
LONDON  
+44 20 7466 2838  
Noe.Minamikata@hsf.com

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